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Ms. Dorothy Attwood
Chief
Common Carrier Bureau
Federal Communications Commission
445 12th Street, SW 5th Floor
Washington, D.C. 20554

Re: **Ex Parte Presentation**
Inter-Carrier Compensation for ISP-Bound Traffic
CC Docket 99-68

Dear Ms. Attwood:

On October 20, 2000, five CLECs submitted an *ex parte* letter ("October 20 *ex parte*) arguing, *inter alia*, that: (1) any past reciprocal compensation problem has been fixed and the Commission accordingly should not implement a bill and keep system for Internet and local traffic unless and until it simultaneously implements a bill and keep system for access traffic; (2) LECs that originate Internet traffic are paid for that service, but LECs who deliver that traffic to an ISP are not; (3) proposals to cap reciprocal compensation payments are anticompetitive; and (4) the establishment of a bill and keep mechanism for Internet and local traffic could result in unwarranted UNE rate increases.[1] BellSouth, Qwest, SBC, and Verizon respectfully submit this response to these arguments.

As discussed below, there is no merit to the CLEC claims. Despite lower reciprocal compensation rates and the migration of some customers to broadband access, reciprocal compensation payments for ISP-bound traffic remain an unjustified subsidy of massive and growing proportions. It is long past time for the Commission to put an end to this subsidy by establishing a bill and keep system for Internet or for Internet and local (including wireless) traffic.

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[1] The CLEC *ex parte* also included proposals for addressing transport costs, FX traffic, and interconnection provisioning. BellSouth, Qwest, SBC, and Verizon will address those proposals in a separate response.

I. The Problem Has Not Been Fixed: Reciprocal Compensation for ISP-Bound Traffic Remains an Enormous Arbitrage Opportunity That Distorts Investment and Diminishes Competition.

The CLECs argue that there is no longer any arbitrage opportunity from reciprocal compensation because states have reduced reciprocal compensation rates to cost-based levels.[2] They argue, further, that the growth of dial-up access is slowing and that, already, the percentage of end users access the Internet through shared lines has dropped to 68%.[3] They thereby imply that any past problem with excessive ISP-related reciprocal compensation has been rectified and ask the Commission to defer any consideration of bill and keep for Internet and local traffic to a forthcoming Notice of Inquiry (NOI) that will raise issues regarding the future of access traffic.

This suggestion by CLECs that lower rates and the availability of broadband access have resolved the reciprocal compensation problem cannot be squared with the facts. Even as reciprocal compensation rates have declined, and some customers have migrated to broadband access, reciprocal compensation payments for Internet traffic have skyrocketed because of the continued rapid growth of dial-up minutes.[4] Indeed, even if the weighted average reciprocal compensation rate in all states were reduced by January 1, 2001, to the ostensible cost-based rate of $.0027 touted by the CLECs, ILECs would be forced to pay about $2.5 billion during 2001 in reciprocal compensation for ISP traffic.[5] During the year 2002, those payments would approach $3.7 billion![6]

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[2] They assert, in particular, that "the weighted average of terminating switching rates ordered by the four largest states that have addressed this issue over the past year is $.0027. October 20 *ex parte* at 1.

[3] *Id.* at 5.

[4] The suggestion in the October 20 *ex parte* that one third of all households already use cable modem or xDSL service lacks credibility. Most analysts agree that the number is about 12% (or less). *See, e.g.,* "The Broadband Report, Reaping What you Sow: ROI in the Broadband Market," Morgan Stanley Dean Witter, May 2000 (projecting 12% broadband penetration in 2001). A General Accounting Office report released this month concluded that broadband penetration is currently about 12%. *See* "Telecommunications, Technological and Regulatory Factors Affecting Consumer Choice of Internet Providers," Report to the Subcommittee on Antitrust, Business Rights and Competition, Committee on the Judiciary, U.S. Senate, October 2000 at 12 (finding that about 88% of households use dial-up access; 9% use cable modem; and 3% use xDSL).

[5] These calculations are based on Wall Street estimates of dial-up minutes. *See ex parte* letter from Robert Blau, Vice President-Executive and Federal Regulatory Affairs, BellSouth to Magalie Roman Salas, Secretary, FCC, CC Docket Nos. 96-98 and 99-68, October 12, 2000 ("October 12 *ex parte*).

[6] If the Commission retains the current reciprocal compensation regime – even for a relatively brief period and even with rate adjustments - those payments would likely exceed these levels because, with the certainty of continued reciprocal compensation payments, CLECs would have the incentive and the ability to heighten even further their focus on the ISP market.

A. Reciprocal Compensation Rates Do Not Reflect CLEC Costs

While the reduced reciprocal compensation rates cited by the CLECs do not, by any stretch of the imagination, solve the reciprocal compensation problem, neither are they cost-based. That is because the reciprocal compensation rates that are currently being established by state commissions have nothing to do with CLEC costs of delivering ISP-bound traffic. Instead, those rates have been based on ILEC costs of terminating local traffic, which are far different and, in fact, higher for reasons that include the following:

- The switching functionality that CLECs provide to their ISP customers is not an end office switching functionality (*i.e.*, a trunk-to-line connection). It is a trunk-to-trunk connection, which is far less expensive – as evidenced by the fact that tandem switching UNE rates tend to be half the UNE rate for end office switching.

- When serving ISPs, CLECs use scaled-down switches with far fewer features than those needed for local traffic. Examples include the Nortel CVX 1800 and Level 3's "managed modem" switch (which Level 3 uses to serve AOL and which, it boasts, can "reap capital savings between 40% and 60%, and operational savings 'that may be even greater.'")[7] They also use modem banks with SS7 signaling capabilities which enable them to bypass the CLEC circuit switch altogether.[8]

- CLECs also "avoid huge transmission costs" by allowing ISPs to collocate in CLEC switching facilities.[9]

The CLECs have steadfastly maintained before this Commission and state PUCs that their costs of delivering Internet traffic are no different from an ILEC's cost of terminating local traffic. At the same time, however, they refuse to document their costs. In fact, in every instance in which a state has ordered them to do so in an arbitration proceeding, the CLEC has withdrawn from the arbitration and adopted the reciprocal compensation provisions of another agreement. Moreover, CLECs tell Wall Street something very different from what they tell state and federal regulators. They tell Wall Street that they enjoy huge efficiencies when they serve ISP customers. Level 3, for example, notes in one of its SEC filings that it has continually declining bandwidth costs in providing services to web centric customers.[10] It also cites other

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[7] Peter Lambert and Paul Bernier, "Level 3 Goes Soft – Lucent Softswitch Investment Expected to Yield Huge Saving," *X-Change*, August 1999 at ¶ 8 (available at http://www.x-changemag.com/articles/981spot.html).

[8] "ISPs Strongarm GTE: UUNet Others Demand SS7 Bypass Savings," *ISP Business News*, Nov. 9, 1998 at 1.

[9] *See* Global NAPs Comments, Exhibit 1, Statement of Fred Goldstein at para. 6.

[10] Level 3, Form 10-K, FY 1999 at 5.

advantages of its network design that enable it "to deliver the lowest unit cost to its customers."[11] Other CLECs make similar claims.

Of course, in the final analysis, the best evidence that CLECs systematically over-recover their costs of serving ISPs is market data. If CLECs merely recovered their costs when they served an ISP, they would be indifferent between serving ISPs and other customers. But the facts show that they are anything but indifferent. Indeed, whereas CLECs predicted at the time of the *Local Competition Order* that there was no reason to expect imbalances between originating and terminating traffic,[12] CLECs overall "terminate" 18 times more traffic than they originate. Moreover, approximately 90% of the minutes for which they collect reciprocal compensation are for Internet traffic.

Significantly, these enormous traffic imbalances have persisted even after reciprocal compensation rates were reduced to levels that the CLECs claim are cost-based. For example, notwithstanding the New York Public Service Commission's reciprocal compensation ruling last year, the traffic ratio in New York has remained approximately 19:1. That, in itself, demonstrates that the lower rates touted by CLECs have not eliminated the arbitrage problem.

In any event, the issue of whether reciprocal compensation rates for Internet traffic are cost-based is a red herring. That is because CLECs that serve an ISP do not require reciprocal compensation at any level to recover their costs. To the contrary, they recover their costs from the ISPs themselves. Any reciprocal compensation they receive on top of their ISP revenues, cost-based or otherwise, represents double recovery.

This is a point that SBC and other ILECs have emphasized throughout this proceeding. It is a critical point because it undercuts any ostensible basis upon which reciprocal compensation for ISP traffic could be rationalized. Until now, it is a point the CLECs have attempted to side-step. In their October 20 *ex parte*, however, they purport to respond to this argument for the first time. They claim that SBC has it wrong and that the LEC that originates an Internet communication is paid in full to carry that traffic to the ISP, while the LEC that serves the ISP is paid nothing for delivering that traffic. As shown below, this argument cannot be squared with the facts or the law.

II. CLECs Do Not Need Any Reciprocal Compensation for ISP-Bound Traffic to Recover Their Costs. Rather, Reciprocal Compensation Gives Them Double Recovery.

As explained by SBC, reciprocal compensation is required today for local traffic because the local service fees collected by LECs are deemed to compensate them for outbound, not inbound traffic. Thus when two LECs collaborate to complete a local call, the originating LEC –

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[11] *Id.* at 7.

[12] *See, e.g.* Time Warner Comments, May 16, 1996, CC Docket No. 96-98 at 97.

which has received compensation for the call – must pay reciprocal compensation to the terminating LEC – which has received no compensation for the call.[13]

In contrast, when two LECs collaborate to deliver Internet traffic to an ISP, the LEC serving the ISP is compensated for the call. That is because ISP-bound traffic is access traffic, not local traffic.

To be sure, as a result of the enhanced service provider (ESP) access charge exemption, the LEC serving the ISP does not receive carrier access charges. The access charge exemption, however, did not institutionalize free access service for ESPs. Rather, ESPs were permitted instead to pay a different amount for their access services – specifically: (1) the business line rate or other state tariffed charges; (2) the special access surcharge to the extent they use special access facilities (as do ISPs); and (3) the subscriber line charge.

That these payments were, in effect, surrogate access charges has been clear from the beginning. In the proceeding in which the ESP exemption was established, the Commission expressly stated that the business line and subscriber line charges paid by ESPs should be deemed to cover, not only the line between the ISP's premises and the LEC's switch, but also the switching function to deliver interstate traffic to the ISP.[14] Significantly, that switching function is the very same function for which reciprocal compensation is paid.[15]

Four years later, in proposing to eliminate the access charge exemption, the Commission expressed concern that "the charges currently paid by enhanced service providers do not contribute sufficiently to the costs of the exchange access facilities they use in offering their services to the public."[16] Thus, here again, the Commission acknowledged that ESPs pay for the access services they receive, even while expressing concern that they may not pay enough to cover the full cost of the entire service.

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[13] The premise of reciprocal compensation is that, although the terminating LEC receives local revenues from its customer, those revenues do not compensate the LEC for inbound traffic, only for outbound traffic.

[14] *See* SBC Comments at 31 *quoting MTS and WATS Market Structure*, 97 FCC 2d 682 (1983) at para. 88: ("Customers instead will remain subject to business local exchange service charges for the line between the reseller or sharer switch, enhanced service node or PBX and the telephone company's switch. In addition, all switching functions will continue to be subsumed under the local business rate") (emphasis added).

[15] In its decision upholding the exemption, the District of Columbia Circuit Court of Appeals has also recognized that ISPs pay for the access services they use, commenting that "the access charges paid by ... ESPs, may thus not fully reflect their relative use of exchange access. *NARUC v. FCC*, 737 F.2d 1095, 1136 (D.C. Cir. 1984) (emphasis added).

[16] *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, Notice of Proposed Rulemaking, 2 FCC Rcd 4305, 4306 (1987) (emphasis added).

More recently, in the *Access Reform Order*, in concluding that incumbent LECs had failed to show that they could not recover their costs of providing access service to ISPs, the Commission noted, *inter alia*, that "ISPs do pay for their connections to incumbent LEC networks by purchasing services under state tariffs."[17] Moreover, the Commission went on to suggest to ILECs that if they could not recover their costs associated with ISP-bound traffic, they should raise the rates they charge their ISP customers.[18]

This invitation extended by the Commission to the ILECs – to seek increases in the rates the ILECs charge their ISP customers in the event they cannot recover their cost of Internet access service – is telling. For one thing, it demonstrates the Commission's belief that ISPs do, in fact, contribute to the cost of the access services they use. In this respect, it refutes the claim made here by the CLECs that ISPs pay nothing for the receipt of ISP-bound traffic. But it is important on another level as well. After all, if an ILEC that serves an ISP must look to that ISP for full cost recovery, why should the same not be true when a CLEC serves that same ISP? Equally important, if ILECs must look to their ISP customers to recover their costs of handling ISP-bound traffic, how can ILECs be asked to pay reciprocal compensation when the ILEC loses the ISP's revenue to a CLEC?[19]

The CLECs do not grapple with these issues. Instead, they purport to rewrite the *Access Reform Order*. Repeatedly in their October 20 *ex parte*, they assert that in the *Access Reform Order*, the Commission invited ILECs to raise the rates they charge ordinary consumers, not ISPs. That, however, is not what the Commission said. What the Commission said was that if ILECs cannot recover their costs of serving customers with high volumes of incoming traffic, they should direct their concerns to state regulators. Ordinary consumers do not have high volumes of incoming traffic; ISPs do.[20] The Commission's invitation was to raise the rates charged to ISPs, not ordinary consumers.

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[17] *Access Charge Reform*, 12 FCC Rcd 15982, 16134 (1997) (*Access Reform Order*) (emphasis added).

[18] *Id.* ("To the extent that some intrastate rate structures fail to compensate incumbent LECs adequately for providing service to customers with high volumes of incoming calls, incumbent LECs may address their concerns to state regulators" (emphasis added).

[19] When a CLEC wins an ISP as a customer, the incumbent LEC loses the revenues it was previously able to collect from the ISP. In that situation, not only is it denied the ability to increase its ISP rates – as the Commission suggested in the *Access Reform Order* - it is unable to collect *anything* from the ISP. To require that same LEC to pay reciprocal compensation in that situation to the LEC that does receive the revenues from the ISP (and is capable of increasing its ISP rates as necessary) is completely backwards. There can be no justification for such a result.

[20] Of course, in suggesting that the Commission has directed ILECs to raise end user rates to cover the costs of reciprocal compensation, the CLECs also avoid any explanation of why the Commission would have concluded that it is appropriate public policy for ordinary end users – including those who do not use the Internet – to finance the costs of Internet use, particularly given that such a policy would amount to a subsidy from those who, on the whole, are less well off than those who tend to be more affluent.

It is not just Commission precedent, however, that shows that a CLEC that delivers traffic to an ISP is paid at least something by the ISP for that service. This is also a matter of plain common sense. After all, a LEC that serves an ISP performs one service and one service only for that ISP: it delivers traffic to that ISP. That LEC is entitled to revenues from that ISP – specifically, the business line rate or other state tariffed charge, the SLC, and the special access surcharge. *If these revenues do not represent compensation for the one function the LEC performs for the ISP, what exactly are they for?* This is a question the CLECs do not and cannot answer.

Instead of answering this fundamental question, the CLECs offer a series of tortured arguments by which they purport to demonstrate that the revenues they receive from their ISP customers are not related to the one service they provide to those customers. They claim that: (1) because the costs of ISP-bound traffic are allocated to the intrastate rate base, those costs are recovered from the customers originating those calls, not the ISPs, and that, to the extent they are not, the Commission has directed the LECs to raise the rates it charges those customers; (2) local business rates were set to recover the costs of outbound traffic, not inbound traffic; (3) the SLC recovers only the interstate cost of the line, not transport and termination; (4) the special access surcharge recovers costs associated with interstate traffic that leaks into the local exchange, not the cost of transporting and terminating traffic to ISP or any other end users because those costs are entirely allocated to the intrastate jurisdiction; (5) the Commission's orders fail to support the claim that ISPs pay for the transport and termination of ISP-bound traffic; and (6) ILECs should be estopped from arguing that CLECs may recover their costs from ISPs. As shown below, these arguments are unavailing.

As an initial matter, it should be noted that, in one respect, at least, the CLECs are correct. The SLC was designed to cover the fixed costs of the local line, not the costs of transport and termination, as defined by the Commission. The CLECs cannot, however, explain away the other revenues they receive from their ISP customers.

First, as shown in Section III below, no credible claim can be made that local rates have, in fact, been set to recover the costs of Internet traffic. It may well be that the costs of ESP traffic are allocated to the intrastate jurisdiction, but local rates were generally based on traffic volumes that preceded the growth of the Internet, and state commissions are not likely to raise local rates now to pay for what the Commission has ruled (and what the CLECs concede) is interstate traffic. Moreover, as discussed above, the Commission has never suggested that ILECs raise consumer rates; rather, it suggested that ILECs raise the rates they charge ISPs.

Second, the fact that ILEC local business rates were set to recover the costs of outbound traffic is irrelevant. For one thing, CLECs do not charge ISPs the ILEC local business line rate; they do not even provide local business lines to their ISP customers. Rather, they provide more sophisticated services, such as ISDN-prime, at rates that they are free to establish themselves. Moreover, if, as CLECs claim, the local business line rate was designed to compensate ILECs for the origination and termination functionalities associated with outbound traffic, surely that rate would provide ample compensation to a CLEC that provides only a "termination" functionality on inbound traffic. In any event, as noted above, in establishing the ESP exemption, the Commission specifically held that the business line revenues received by ESPs are deemed to

cover the cost of the line between the ESP premises and the LEC switch as well as the cost of switching traffic to the ESP premises.

Third, the CLECs' discussion of the special access surcharge is nothing but a smokescreen. The CLECs maintain that special access surcharge revenues should be disregarded because those revenues recover costs associated with interstate traffic, while costs associated with ISP traffic are allocated to the intrastate jurisdiction. But the fact that ISP costs are allocated to the intrastate jurisdiction has no bearing on whether the special access surcharge recovers the same costs to which reciprocal compensation is directed – *i.e.*, the costs of transport and "termination." In fact, all traffic to which the special access surcharge applies is treated as intrastate for separations purposes. The whole point of the special access surcharge is to compensate carriers for interstate traffic, such as leaky PBX traffic, that cannot practicably be distinguished from local traffic. The special access surcharge is designed to serve as a substitute access charge – a way of making up for the access charges that would have applied to the traffic if it could be identified as interstate traffic.[21] Just as carrier access charges cover the costs of transport and switching, so too does the special access surcharge that stands in its place.[22]

Fourth, the claim that the access charge exemption effectively relieved ISPs from having to pay anything for their access services is wrong as a matter of law and plain common sense. As the Commission itself has recognized, the access charge exemption did not transform access traffic into local traffic; it simply permitted ESPs to continue paying local business line rates (augmented by the special access surcharge) for their switched access connections. [23] Moreover, as noted, the CLECs' argument cannot be squared with a long line of precedent, including the *Access Reform Order*, in which the Commission expressly acknowledged that ISPs contribute to the costs of the access services they use.

According to the CLECs, the fact that the exemption represented a continuation of the status quo, pursuant to which ESPs connected to their customers via local business lines, demonstrates that the originating end user, not the ISP, pays for this connection. That assertion

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[21] As the Commission explained: "[i]deally the ... surcharge should be set a level which yields overall revenues representative of the revenues foregone on account of users obtaining access services at local telephone service rates. In other words, the aggregate surcharge revenues serve as a surrogate for the interstate access charges which would be collected if leaky PBX usage could be quantified and identified as to source." *MTS and WATS Market Structure*, 97 FCC 2d 682 (1983) at para. 86.

[22] The CLECs suggest further in a footnote that because the special access circuits used by an ISP may not be provided by the LEC delivering inbound traffic to that ISP, that LEC would not receive the special access surcharge. That is wrong. The Commission expressly held in its order establishing the special access surcharge that when an ESP obtains private line circuits from a LEC other than the LEC that delivers its inbound traffic, the LEC delivering the inbound traffic is entitled to the surcharge and the Commission's rules still so provide. *Id. See also* 47 CFR 69.115(d).

[23] As the Commission recognized in the *Reciprocal Compensation Declaratory Ruling*, ISPs "use interstate access services ... [but] pay local business rates and interstate subscriber line charges for their switched access connections to local exchange company central offices." *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 14 FCC Rcd 3689 at para. 5 (1999).

is inconsistent with how the Commission has repeatedly characterized the exemption, and, tellingly, the CLECs contradict their own premise when they concede that "the point of the Commission's decision to continue treating ISPs ... as end users was that nothing (except the new obligation to pay the nominal special access surcharge) would change about the way ISPs paid for connecting to the network."[24]

Finally, in a last ditch effort to deflect attention from the real issues, the CLECs suggest that ILECs should be estopped from claiming that CLECs can recover their costs from the ISPs on the ground that, in the *Access Reform* proceeding, the ILECs argued that they (the ILECs) could not recover their costs of providing Internet access service. But in the *Access Reform* proceeding, incumbent LECs claimed that the revenues received from their ISP customers do not cover the costs of originating, transporting, and delivering Internet traffic from the end user to the ISP. When a CLEC serves an ISP and seeks reciprocal compensation, it does not perform these three functions. It does not incur the cost of originating traffic, nor, as a general matter, does it incur transport costs. It simply incurs switching costs at the "terminating" end. These costs are a far cry from the costs an incumbent LEC incurs when it is responsible for the originating, transport, and delivery of the traffic.

III. The Commission Should Cap Reciprocal Compensation Payments as it Transitions to Bill and Keep for Internet and Local Traffic.

The CLECs also argue that any cap on reciprocal compensation rates would be anticompetitive. Proceeding from the faulty premise that reciprocal compensation payments are now cost-based, and ignoring that such payments provide double recovery, they claim that the ILECs have offered no justification for caps that would reduce reciprocal compensation payments. They argue that "[w]hile the ILECs often complain of alleged revenue shortfalls due to ISP bound calls ... not a single credible study has been placed in the record in this proceeding that demonstrates any such shortfall[.]"[25] Citing the *Access Reform Order,* they also repeat their argument that, to the extent ILECs are not adequately compensated for Internet traffic, the Commission has already directed them to address their concerns to state regulators.

These arguments mis-characterize the nature of and basis for the proposed cap mechanism. As an initial matter, ILECs do not propose caps on reciprocal compensation rates. As shown above and in the October 12 *ex parte*, a cap on reciprocal compensation rates will not translate into meaningful reductions in reciprocal compensation payments unless the rates are capped at levels that are radically lower than prevailing rates. Accordingly, ILECs have proposed a traffic ratio mechanism that, in effect, caps reciprocal compensation payments. Specifically, they have proposed that the Commission use caps to ramp-down reciprocal compensation payments over the course of a brief, reasonable transition to bill and keep for Internet or for both Internet and local traffic.

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[24] October 20 *ex parte* at 8 (emphasis changed).

[25] CLEC *ex parte* at 5.

Second, the cap proposal is not based entirely on claims of revenue shortfalls, as the October 20 *ex parte* suggests. To be sure, revenue shortfalls associated with Internet traffic represent one good reason to eliminate reciprocal compensation for ISP traffic altogether. But there are other compelling reasons why the Commission may wish to consider caps.

One such reason is that a cap mechanism is a particularly well-suited transition mechanism to bill and keep.[26] Although it is not clear why the Commission could not order the immediate implementation of a bill and keep system for Internet traffic,[27] the Commission might conclude that a flash-cut to bill and keep could be disruptive to certain carriers. In that event, caps would allow the phase-out of reciprocal compensation payments over a reasonable period of time.[28]

The Commission, of course, has ample authority to phase-out a regulatory requirement over time. In fact, it has done so on countless occasions. For example, the Commission ordered a gradual phase-out of a portion of the transport interconnection charge (TIC) when it ordered LECs to migrate those charges over time into the tandem switching rate element.[29] More

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[26] Because ISP-bound traffic is not subject to the reciprocal compensation provisions of the Act, there can be no question as to the Commission's authority to establish a bill and keep mechanism for ISP-bound traffic. Even if the Commission were to conclude, however, that ISP-bound traffic is subject to the reciprocal compensation provisions of the Act, it could still order bill and keep for that traffic. Although the Commission held in the *Local Competition Order*, that states may require bill and keep only for local traffic that is balanced, those rules do not speak to Internet traffic. Rather, the Commission has concluded that it has no rules regarding compensation for Internet traffic. Moreover, petitions for reconsideration of the *Local Competition Order* remain outstanding. That being the case, the Commission is free to reconsider its rules regarding bill and keep for local traffic. Certainly, there would appear to be a strong case that the Commission mis-read section 252(d)(2)(B)(i) when it concluded that bill and keep is permitted only for balanced traffic. That provision clearly authorizes bill and keep whenever the Commission concludes that carriers have a mutual opportunity to recover their costs through a bill and keep mechanism. Moreover, it has become apparent in the four years since the adoption of the *Local Competition Order* that the public policy assumptions underlying the Commission's rule were wrong. It is reciprocal compensation, not bill and keep, that distorts telecommunications markets.

[27] LECs have been on notice since at least February 1999 that reciprocal compensation for Internet traffic could end, and the application of section 251(b)(5) to Internet traffic has been in dispute since the spring of 1997. Moreover, some states already have established a bill and keep system for Internet traffic, and they did so without any transition.

[28] Of course, existing interconnection agreements represent another transition vehicle. BellSouth, Qwest, SBC, and Verizon emphasize, in this regard, that they do not ask the Commission to abrogate existing interconnection agreements. Some interconnection agreements contain change of law provisions; others do not. To the extent an interconnection agreement does not contain a change of law provision, that agreement would presumably be unaffected by new Commission rules. On the other hand, to the extent the agreement contains an applicable change of law provision, that provision is as much a part of the agreement as any other provision and should apply.

[29] *Access Reform Order* at paras. 166-169.

recently, in the *CALLS* proceeding, the Commission, having determined that switched access rates should be reduced (for most ILECs) to $.0055, ordered that those reductions should be implemented over time through the operation of the x-factor.[30] Of course, these are just two of many examples.

Another independent basis upon which the Commission could establish caps is to reduce inappropriate regulatory arbitrage. Currently, incumbent LECs originate 18 times as much traffic to CLECs as they terminate from CLECs, and 90% of the traffic for which CLECs bill reciprocal compensation is for Internet traffic. These data document a significant regulatory dysfunction. The only explanation for such huge traffic imbalances is that reciprocal compensation payments, not market forces, are driving business decisions. In fact, in Iowa – which implemented bill and keep from the start – the traffic ratio is 1.3 to 1 and less than 1/2 of all minutes originated by Qwest for which CLECs bill reciprocal compensation are for Internet traffic. In Iowa, the market is dictating investment decisions; in most other places, reciprocal compensation is the driver.

The huge traffic imbalances caused by reciprocal compensation are not what Congress intended when it adopted the 1996 Act. Congress sought to establish a deregulatory national framework driven by market forces, not a regime in which Government regulation co-opts the market and dictates investment. Moreover, its expectation was that the reciprocal compensation provisions of the Act would lead to broad-based local competition, not targeted efforts by carriers to game the system.

There can be no doubt that the Commission has the authority and the responsibility to address this problem. Indeed, the Commission has already recognized that states may deny reciprocal compensation altogether to an entity that predominantly or exclusively serves ISPs to the exclusion of other customers.[31] If the states have the authority to deny reciprocal compensation to entities engaged in regulatory gamesmanship, surely the Commission – which has been charged with the responsibility for establishing rules implementing the reciprocal compensation provisions of the Act – has the same authority. It should exercise that authority by establishing caps on the ratio of "terminating" to originating traffic during any transition to bill and keep.

A. ILECs Do Not Recover Their Costs From End-User Revenues

Although, as noted, the proposal that the Commission cap reciprocal compensation payments is not based on claims of revenue shortfalls, the CLECs' statement that "not a single credible study has been placed in the record in this proceeding that demonstrates any such shortfall" is flatly false and should not pass without response. In comments, filed April 12, 1999, Ameritech submitted a study which demonstrated that, even without paying reciprocal compensation, Ameritech's end user revenues do not cover its costs of originating ISP traffic. That study actually substantially overstated Ameritech's end user revenues because it assumed, for purposes of the analysis, that all end-users purchase a second line for Internet access and it

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30 *CALLS Order*, FCC 00-193, para. 160 (Rel. May 31, 2000)

31 *Reciprocal Compensation Declaratory Ruling* at para. 24.

attributed all of the retail revenues from the sale of those second lines to ISP traffic. In calculating its costs, Ameritech used state-approved TELRIC rates.

The CLECs' October 20 *ex parte* represents that the Ameritech study was "soundly discredited by an economist."[32] The economist to which they refer, however, systematically understated Ameritech's costs by calculating those costs with reference to a short-run marginal cost analysis instead of a TELRIC-based analysis. [33] He also mischaracterized Ameritech's study, misquoted testimony from state proceedings, and committed calculation errors – all of which is documented in an analysis by LECG, Inc. filed by SBC on December 14, 1999.

Of course, here again, common sense is the trump card. Internet traffic volumes have been exploding since 1997 – by some accounts doubling every 100 days. Yet, by and large, basic local service rates have not been increased in years.[34] In the five Southwestern Bell states, for example, rates for basic residential service have not changed since the 1980s. In Illinois, current rates have been in effect since January 1990.

Moreover, the cost of traffic origination aside, the reciprocal compensation payments associated with ISP traffic themselves consume a significant portion of end user revenues. For example, in their lobbying efforts before Congress, CLECs recently circulated materials in which they claimed that they receive an average of $6.60 per consumer per month in ISP-related reciprocal compensation. This amounts to almost half of the monthly rate for local service paid by a typical end user. CLECs have presented no basis upon which the Commission could conclude that ILECs recover, not only their costs of originating and transporting Internet traffic to the CLEC point of interconnection, but also the costs of reciprocal compensation.

The CLECs claim that if the ILECs do not, in fact, recover their costs from their end users, they should do so. Referring to the *Access Reform Order*, they claim "this Commission

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[32] CLEC *ex parte* at 5.

[33] Ironically, even as the CLECs endorse a study that calculated Ameritech's costs with reference to a short-run marginal cost analysis, they ask the Commission to affirm that reciprocal compensation rates must be based on TELRIC principles, even though the statutory standard for calculating reciprocal compensation (the "additional costs" of transport and termination), unlike TELRIC, is a pure incremental cost standard. *See* October 12 *ex parte* at 10. If it is legitimate to assess Ameritech's costs of originating ISP traffic with reference to a short-run marginal cost analysis, then surely the CLECs' costs of delivering ISP-bound traffic should be gauged by the same standard. It should thus be up to them to show that they cannot reasonably recover their short-run marginal cost of delivering traffic to an ISP from their ISP revenues.

[34] The CLECs maintain that large states such as Illinois and New York have minute of use local calling rates. These are two of fifty states. Moreover, even in these states, the CLECs have their facts wrong. In New York, residential customers pay either flat rates or, if they are in the New York metropolitan area, per-call rates. In Illinois, residential customers pay per-call rates, not per-minute rates, for most of their local calls. Significantly, these per-call rates have not been increased despite the fact that the average Internet connection is ten times as long as the average local call.

has already directed the ILECs to address their concerns to the state commissions[,]"[35] thereby implying that the ILECs have been told that if they cannot recover their costs, they should raise the rates they charge end users. As noted, however, that is not what the Commission said. What the FCC, in fact, said was that if ILECs cannot recover their costs of serving customers with high volumes of incoming traffic, they should direct their concerns to state regulators. The FCC thus invited LECs to seek increases in the rates they charge ISPs (who have high volumes of incoming traffic), not the rates they charge ordinary end users.

IV. A Bill and Keep System Will Not Lead to Higher UNE Rates

CLECs argue further that the Commission should continue requiring reciprocal compensation to restrain an ILEC's ability to argue for "novel and unfounded cost positions." CLECs provide no evidence whatsoever that the states are unable at this juncture – four years after enactment of the 1996 Act – to evaluate the merits of a cost study on its own terms. They provide no evidence of any linkage between excessive UNE rates and a bill and keep system for reciprocal compensation. They provide no evidence that ILECs ever have lowered their UNE rates as part of a strategy to avoid reciprocal compensation liability. In fact, they provide no evidence at all, just scare tactics.

There is good reason why the CLECs cannot produce any evidence that a bill and keep reciprocal compensation system would have an impact on UNE rates: the evidence is to the contrary. In the Qwest region, a number of states have moved to a bill and keep system for Internet or even local traffic, and as shown in the attached chart, UNE rates are no higher in these states than elsewhere. In fact, in Iowa, which has always been a bill and keep state, UNE rates are lower than average.

Moreover, even as a matter of theory, the CLEC argument is implausible. This is not 1996; the states are not starting from a clean slate. They have had four years to review cost studies and models submitted by ILECs and CLECs – four years during which ILECs generally were forced to pay reciprocal compensation for ISP traffic. Particularly in light of the record already compiled, the ILECs cannot simply turn around and sell unjustified UNE rate increases to the states. Surely the states are not so helpless that they are incapable of evaluating the merits of any change made to an ILEC cost study after the implementation of bill and keep.

The dysfunctional nature of the reciprocal compensation regime is not just hypothetical. The huge traffic imbalances and the enormous subsidies that are being paid are testament to that. A mere theory, belied by all available evidence, the premise of which is that state commissions cannot discharge their responsibilities, is hardly reason to avoid fixing the reciprocal compensation problem.

Tinkering around the edges by lowering rates is not the answer. Even with lower rates, reciprocal compensation payments continue to skyrocket because of the rapid growth of dial-up Internet access minutes. The reciprocal compensation regime is grossly inequitable and cannot be reconciled with the goals of the 1996 Act. It is long past time for the Commission to take

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35 October 20 *ex parte* at 9..

decisive action. The Commission should implement the only solution that will put the focus back on competition for all customers. It should implement a bill and keep system now.

Sincerely,

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Attachment

Over time, Qwest's Cost Advocacy for Switching Has Not Changed, in Spite of Increasing Net Reciprocal Compensation Payments to CLECs

State	Filed Study Date	Filed TELRIC + Common Cost	State Ordered Internet Reciprocal Compensation?	Ordered Rate (Arbitrated if no Cost Docket)
• **Oregon**	08/01/1996	$ 0.002880	Yes	$ 0.001330
• **Nebraska**	08/01/1996	$ 0.003082	Yes	$ 0.003682
• **Washington**	08/01/1996	$ 0.002671	Yes	$ 0.001200
• **Montana**	09/01/1996	$ 0.003655	No Decision	$ 0.002900
• **New Mexico**	09/01/1996	$ 0.003013	Yes	$ 0.001108
• **North Dakota**	09/01/1996	$ 0.003302	No	$ 0.002500
• **Utah**			Yes	
– Urban	09/01/1996	$ 0.003298		$ 0.002299
– Suburban	09/01/1996	$ 0.003120		$ 0.002664
– Rural	09/01/1996	$ 0.004013		$ 0.002896
• **Colorado**	11/01/1996	$ 0.003083	No / Eff. May 2000	$ 0.002830
• **Idaho**	01/01/1997	$ 0.003421	No Decision	$ 0.002900
• **Arizona**	02/01/1997	$ 0.002947	No / Eff. June 2000	$ 0.002800
• **Minnesota**	03/01/1997	$ 0.003205	Yes	$ 0.001813
• **Iowa**	07/01/1997	$ 0.003237	No	$ 0.002130
• **Wyoming**	10/12/1998	$ 0.003753	No Decision	$ 0.003753
• **South Dakota**	03/04/1999	$ 0.003469	No	$ 0.003469

- The costs filed by QWEST are not influenced by whether a state orders reciprocal compensation on Internet traffic. Note that filed costs from 8/1/96 through 3/4/99 do not trend up or down over time.